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Prime Minister

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I have discussed this proposal with Peter Middleton who believes that – as an interim arrangement until the reserve asset ratio is abolished at the time of the Budget – it is the best available. Its purpose is much the same as special Bank assistance – i.e. to prevent a major cash shortage developing when the govt. accounts go into surplus. (You will recall that Gordon Pepper accepts that assistance at a time of surplus is correct.) The Bank want to announce on Friday. Are you content?

Agreed but it will be misunderstood unless very careful briefing is given now

cc Mr Gaffin

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

23 December 1980

T P Lankester Esq
Private Secretary
Prime Minister's Office
No.10 Downing Street
LONDON SW1

Dear Tim,

THE BANKS' RESERVE ASSETS RATIO

At the Prime Minister's meeting on 18 November, it was agreed that the reserve assets ratio (RAR) could not be abolished until new prudential guidelines had been established, and that this could not be done before the Budget. However, it was also agreed that it would be desirable to consider an interim change to avoid, if possible, the need for special Bank assistance to the market in the first quarter of 1981, when the central government surplus will drain cash out of the system.

The Chancellor and the Governor have concluded that such a change could indeed be made. A reduction in the ratio from 12½% to 10% of banks' eligible liabilities should just enable the banking system to get through the revenue quarter without further sale and repurchase operations in gilts. It accords with the approach to the new prudential system of recognising that liquid assets are there to be run down at times of pressure. No prudential risks would be created. The reduction would not prejudge decisions on future monetary controls or future prudential guidelines. The Chancellor and the Governor therefore propose to announce the reduction early in January, when the central government goes into surplus.

The scale of the problem is as follows. On present projections, the Government surplus is likely to take the cumulative cash shortage in the market from nearly £900 million at the end of banking December to about £3.2 billion by the end of banking April. (The shortage could be smaller if the Government's first quarter surplus falls short of the forecast or larger if sales of Government debt are higher than is projected.) The Bank must meet

/this shortage by

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Since the RA ratio is being phased out anyway next March, reducing it to 10% will be less open to misunderstanding than repeating last year's massive special assistance.

this shortage by converting other assets into cash, unless short term interest rates are to rise in a way entirely inconsistent with the reduction in MLR and unhelpful to monetary control (because the increase in market interest rates would simply encourage round-tripping).

The additional cash shortage in the first quarter will be of roughly the same order of magnitude as in the revenue quarter last year; but the problem of alleviating it will be more difficult for two reasons. First, there are no special deposits to release, as there were in the first quarter of 1981. Second, we start 1981, unlike 1980, with the Bank already providing nearly £900 million of assistance, mainly through purchases of commercial bills. Nonetheless, the problem should be manageable provided the RAR is reduced.

A reduction from 12½% to 10% will release something over £1½ billion of reserves to be converted into cash. The amount by which the Bank's need to buy in commercial bills will be reduced may well be somewhat smaller. It depends how far the banking system is prepared to run down its holdings of reserve asset claims on the public sector (ie Treasury Bills and local authority bills). The Bank judges that the reduction in such assets might not exceed £1 billion, but that it is right to make room for a somewhat larger reduction in case it proves possible.

If the reduction amounts to £1 billion, some £2 billion will remain to be provided by purchase of other assets. The Bank will aim to do so by buying in commercial bills and, to a lesser extent, swapping the banks' foreign currency holdings into sterling. This should be just possible without recourse to special arrangements.

To reduce the RAR below 10% would not reduce the need for the Bank to buy in commercial bills because the ability of the banking system to run down its holdings of reserve asset claims on the public sector would be already exhausted - if not more than exhausted - by the reduction to 10%. Nor would it help to allow more private sector assets to count as reserves, for the same reason. Nor would it help to bring in gilts over one year (the present boundary), because this would make them more attractive to banks, and so could conflict with the objective of broadening the market in central government debt of this maturity.

/The Chancellor and

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The Chancellor and the Governor are satisfied that to reduce the RAR to 10% is the right course to follow in the circumstances. If the Prime Minister is content, the Bank of England will announce the change on or about 5 January.

Brought forward to Friday.

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I am copying this letter to Tim Allen at the Bank of England.

yours

John

A J WIGGINS
Principal Private Secretary